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INSTITUTIONAL DEVELOPMENT FOR MACROECONOMIC POLICY MANAGEMENT AND COORDINATION

(Item 4 of the provisional agenda)

Note by the secretariat

SUMMARY

While development of a sound institutional capacity for macroeconomic policy design and implementation has not been a widely discussed topic, experience in the developing countries of East and South-East Asia suggests that efforts to develop their institutions have been crucial to their success in economic development.

The ESCAP secretariat has been executing a project on the identification of the institutional constraints of least developed countries in implementing macroeconomic policies and lessons from East and South-East Asian countries, based on studies undertaken in five countries: Bangladesh, the Lao People's Democratic Republic, the Republic of Korea, Thailand and Samoa. This report provides a brief summary of the major issues identified, the experiences of countries and the recommendations formulated under this project. It is hoped that the lessons from these countries may be useful for other least developed countries.

The Special Body may wish to take note of and endorse the recommendations of this report for presentation to the Commission at its fifty-third session.

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I. CONCEPTUAL ISSUES

1. The goal of macroeconomic policy is to maintain an equilibrium in the monetary sector of an economy through a combination of monetary, fiscal and exchange rate policies. To achieve this, policy makers face the difficult problem of devising an optimal policy mix and choosing appropriate policy instruments. With no unambiguous theoretical guidance, they have had to experiment with various possible policy mixes. Often, the outcome is temporary and eclectic in nature; hence continuous policy evaluation and revision are required. To deal with such complications sound institutional capacity is needed.

2. Since macroeconomic equilibrium is a result of interactions between economic conditions, policy regime and institutional capacity, an evaluation of the role of institutions in shaping the macroeconomic environment is complicated. An inconsistent or incompatible policy regime, rather than weaknesses in institutional capacity, may be responsible for a macroeconomic crisis. An incompatible policy regime, however, is often the result of poor institutional capacity. While technical capacity is critical in devising compatible policies, institutional coordination and credibility often greatly affect policy implementation.

3. Several factors contribute to the institutional capacity to implement macroeconomic policies. First, the institutions responsible for macroeconomic policy, namely the central bank, the ministry of finance and the planning body, should be capable of properly performing their functions. Second, policy coordination among the institutions, as well as with agencies responsible for sectoral policies, is important to ensure policy consistency and to minimize conflicts. Third, the degree of autonomy of the institutions from ad hoc interference affects their ability to provide the political authorities who make the final decision with professional policy analysis and recommendations. Finally, it is necessary to have a legal framework which guarantees certain economic rights, enforces contracts and provides the articulation of sectoral economic activities. An institutional constraint on implementing macroeconomic policies may be interpreted as the absence of any of these factors.

4. It should be noted, however, that macroeconomic policy operates on the demand side and is only fully effective when aggregate supply is flexible. When aggregate supply is rigid or unstable, the resulting macroeconomic disequilibrium is unlikely to be stabilized by demand-side policies alone. In this case, relevant supply-side policies matter, including those which aim at a compatible set of trade and industrial policies. However, the design and implementation of trade and industrial policies can also complicate macroeconomic policy, as they often involve monetary, fiscal or exchange rate measures which conflict with macroeconomic policy objectives. Thus, managing consistent and compatible macro and sectoral economic policies is indispensable. This, in turn, implies an institutional coordinating mechanism between the macroeconomic policy agencies and the sectoral ministries.

5. In addition, economic development brings structural and institutional changes which affect the design of macroeconomic policies. Financial deepening is a case in point; with the development of financial markets, the range of instruments for monetary policy widens. Moreover, the flexibility and composition of the tax structure changes, with revenues from direct taxes increasing, and with the broadening and simplification of indirect taxes by using value-added-based calculations. Such structural changes impose new, often more difficult, demands on the institutions responsible for the policies.

6. Global integration further complicates macroeconomic policy implementation. As the speed of the adjustment in the international financial variables increases, institutions responsible for macroeconomic policies need to have a forward-looking outlook which integrates short and medium-run plans and ensures cross-sectoral policy consistency within a dynamic context. Clearly, this is a tall order: it requires not only a better institutional coordination framework among various government ministries and agencies (and with the private sector) but also new organizational and human skills within the institutions.

II. THE INSTITUTIONAL FRAMEWORK

7. Textbook discussions on macroeconomic policy implicitly assume a well functioning institutional framework with clear institutional mandates and coordination mechanisms and elaborate financial (and other) markets that instantaneously facilitate the transmission of policy signals. The real world is, however, something else. Institutional shortcomings are often the most intractable problems. And the rigidities within the macroeconomic system often thwart the transmission mechanisms.

8. A unique institutional framework for the execution of macroeconomic policy does not apply to all countries; a suitable institutional framework depends critically, among others things, on the nature and stage of development and a country's historical legacy. In most developing countries a triumvirate of institutions is responsible for macroeconomic policy formulation and implementation, namely the central bank, the ministry of finance and the planning body. Each of these institutions has a distinct mandate and powers. While in developed countries only the former two exist, most developing countries have a planning body to manage the overall direction of development efforts. Its role in maintaining strategic consistency between short-run macroeconomic policy and long-term development goals is essential. While the final authority for presenting macroeconomic policy usually rests with the ministry of finance, some coordination framework exists to promote synergy in policy-making and implementation. Since the economic environment in developing countries is generally characterized by relatively high uncertainty, policy consistency and institutional credibility matter crucially in shaping the confidence of economic actors in the economy. When an economy is prone to various shocks, the degree of institutional flexibility to cope with crises is an important factor in its success. Moreover, in small countries, close coordination between the triumvirate institutions serves

to economize scarce human and other institutional capital.

A. The central bank

9. The principal mandate of the central bank is to formulate monetary (and usually exchange rate) policies with the objective of safeguarding price stability. It is also responsible for the supervision of the banking system. These two mandates are fundamental and closely intertwined; the conduct of monetary policy is almost impossible when central bank supervision of the financial institutions is not effective.

10. The relative independence of the central bank from the government is often viewed as vital to its credibility and the effectiveness of its policy design and implementation. However, close coordination of the central bank with other ministries and government agencies may be equally important. A major challenge in developing countries is to suppress inflationary tendencies rooted in the expectations of economic actors and certain institutional arrangements. This requires concerted action and firm determination among all government institutions, rather than the central bank working in an independent capacity.[1] Successful macroeconomic stabilization often indicates that there has been a high degree of coordination between the central bank and government ministries and agencies. Moreover, when a central bank has a say in the budgetary process, this should further enhance the compatibility of the macroeconomic policy regime.

11. In the five sample countries used as case studies for an ESCAP project on the identification of the institutional constraints of least developed countries in implementing macroeconomic policies and lessons from East and South-East Asian countries, the relative degree of independence of the central banks was more or less similar. However there were substantial differences in their institutional credibility. Such credibility is built on a strong institutional capacity (well developed human resources and quality research), professional supervision of the financial sector, a well articulated and consistent policy stance and skill in various forms of market intervention.

12. The central bank usually has a high degree of freedom in the exercise of monetary or exchange rate policy and financial sector supervision. The choice of the policy instruments and timing of policy action are within its discretion. A central bank has three basic instruments for influencing the money supply: reserve ratio requirement, discount rate policy and open market operations. The viability of these instruments presupposes a well functioning financial sector and, in the case of the latter instrument, elaborate financial markets. When the financial market is imperfect

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[1] See, for instance, contrasting views presented by A. Cukierman, S.B. Webb and B. Neyapati, "Measuring the independence of central banks and its effects on policy outcome," *The World Bank Economic Review*, vol. 6, No. 3 (1992) and I. Mas, "Central bank independence: a critical view from a developing country's perspective," *World Development*, vol. 23, No. 10 (1995).

and thin, central bank monetary policy is bound to be less effective. Thus the implementation of monetary policy requires a good supervisory capacity in the central bank in its enforcement of prudential rules. Also important is the scope of its supervision. There is a growing trend to extend this to non-bank financial institutions as financial deepening occurs.

13. The Bank of Thailand is a case in point. Its hard won credibility owes much to a solid human resources development programme, high quality policy research papers and other technical capabilities in formulating and conducting monetary and exchange rate policies, all of which have been built up consciously and consistently over a long period of time. In addition, various consultants and think tanks have been providing the Bank with invaluable policy inputs. Thus, while the governor is for all practical purposes a member of the government, the bank is often viewed as being the major guardian of macroeconomic stability, especially in maintaining stable prices and exchange rates.

14. Central bank credibility that is built up over time generates a constituency in support of the bank's policy stance. As public awareness grows, it becomes difficult for governments to change the course of monetary policy, moving away from the goal of price stability. The use of a proactive public campaign in the Republic of Korea has helped ease the central bank's task in controlling inflation. In addition, intense public debates on economic policy issues go on almost daily in the Republic of Korea, Thailand and elsewhere in East and South-East Asia, and this helps create public support for prudential macroeconomic management, thus putting additional pressure on governments to avoid fiscal profligacy.

15. The importance of a central bank's efforts to develop and supervise the financial sector has increased substantially in the wake of financial liberalization. This process also poses serious challenges to the capacity-building of the central bank itself. The rapid rise of non-bank financial institutions that are engaged in the provision of loans complicates the conduct of monetary policy and, as these are frequently beyond the reach of the central bank's supervisory arm, the implementation of the prudential rules becomes difficult. While there is awareness in the sample countries regarding this matter, there is an urgent need for measures to supervise the non-bank financial institutions through new financial laws, as well as to develop expertise on the nature and practices of these institutions. In addition, managing a more open and globally integrated financial sector requires a capacity for cross-border coordination in the supervision of financial institutions.

16. Managing an efficient exchange rate policy presupposes that the central bank has adequate data and information on the money market, solid research, and trading skills, as well as an adequate foreign exchange reserve in excess of that needed to cover immediate import requirements. While an institutional capacity for monitoring and analysing the economic situation is important for implementing other macroeconomic policies, such capacity is imperative when a central bank conducts

an exchange rate policy. This is because the speed of adjustment in the exchange rate is extremely fast and generally outpaces that of other macroeconomic variables, and so the phenomenon of overshoot or undershoot of the exchange rate is frequently observed. It is vital for the central bank to have the capability to differentiate between a temporary change or a speculative attack on the exchange rate (when the central bank should defend the domestic currency) and a permanent one (when appreciation or depreciation is inevitable).

17. Finally, another related issue in institution-building is the availability of relevant and timely information for economic monitoring. Very often such data are not available in the least developed sample countries, thus making it difficult for the central bankers to assess the current situation and, consequently, to implement appropriate policies and take corrective action.

B. Ministry of finance

18. In most developing countries, including the sample countries under this project, the prime responsibility for macroeconomic policy rests with the ministry of finance. Therefore its leadership capacity matters crucially. Essentially an integral part of the government, the ministry of finance normally commands high respect, especially when it is capable of exercising prudent macroeconomic management over a long period of time.

19. In practice, however, the formulation and conduct of fiscal policy has been the principal domain of the ministry of finance, with the budgetary process (both revenue and expenditure) being the main component. Unlike the case with monetary policy, the conduct of fiscal policy is more rigid as the budgetary process is lengthy, involving a relatively long-term commitment of financial resources, typically for one fiscal year, and requires legislative approval. In all the countries studied, the budgetary process involved coordination with other ministries and, for capital expenditure, the role of the planning body in project appraisal was significant.

20. Marketization of an economy has implications for the tax structure and its composition which, in turn, are reflected in the size of and variations in government revenues. The role of the tax structure is important particularly with regard to its potential counter-cyclical nature. Generally speaking, when the tax base is reasonably broad and its structure follows a value-added base calculation, then the pattern and trend of the government revenues coincide with the cycle in the economy at large. The situation is different when a substantial portion of the government revenue is based on international trade taxes, as has been or still is the case in many least developed countries. The institutional capacity to determine the tax structure and rates and for efficient and effective tax collection is thus important. The relatively low tax collection rates in Bangladesh, the Lao People's Democratic Republic and Samoa may be partly attributed to the lack of development of these capabilities. In addition, public

campaigns to support tax collection are needed to instil in the public a willingness to pay taxes; this has been done successfully in East and South-East Asian countries. It is likely that more efforts to promote public policy debates and campaigns are needed in the other sample countries where public discussions on this issue are relatively scanty.

21. In the cases of both the Republic of Korea and Thailand, the policy-making and implementation capacity of the ministry has depended critically on its ability to attract highly skilled professionals, the availability and quality of data and information, and the quality of their associated consultants and think tanks. In addition, the capacity of the ministry of finance to resist pressure from other ministries or parliament for more spending helps to increase its policy credibility, thus creating stable and predictable expectations from the public. As in the case of monetary policy, public debates on government expenditure occur almost daily in the Republic of Korea, Thailand and other countries in East and South-East Asia and help create a constituency in support of prudent budget management.

22. When an economy is opening, the effectiveness of monetary policy in stabilizing domestic demand declines (while at the same time the policy of the central bank shifts towards stabilization of the exchange rate), and the burden of stabilizing domestic demand shifts to a greater extent to the execution of a sound fiscal policy. It is often prudent to have a set of binding constraints on the government budget, as in the case of Thailand. What is also important is the coordination mechanism of the budgetary process. In both the Republic of Korea and Thailand, the budgetary process involves various coordination schemes among government ministries and agencies to ensure the mechanism of checks and balances. At some critical points of the process, outside evaluations by think tanks are also involved.

23. A formal institutional coordination framework for the budgetary process, such as that in Thailand and the Republic of Korea also exists in the least developed countries. However, policy implementation is often hampered by the lack of resources (human, financial and managerial) as well as political will. These shortcomings need to be addressed urgently, as many domestic macroeconomic imbalances have emanated from profligate fiscal policy as well as inefficient or ineffective fiscal policy implementation.

C. Planning body

24. Everywhere in the developing countries planning bodies exist. Their main role in the countries studied is broadly similar: to exercise strategic management in the course of economic development, usually through the formulation and control of a medium- to long-term plan. Within the context of macroeconomic policy-making, the planning bodies in the sample countries exert a major influence on fiscal policy, particularly as regards the capital expenditure part of the budget, to ensure that projects satisfy efficiency criteria and are consistent with the overall long-term plan.

25. Although the planning body does not implement macroeconomic policy, or for that matter, any other government policies, its role is vital as it stretches the essentially short-term and narrow horizon of the macroeconomic policy longer and broader. This is especially true when the economy is coping with difficult problems of structural transformation. For example, there is a vital need to ensure cross-sectoral policy consistency during this process. There is also a need to evaluate a number of trade-offs encompassing growth and stability, growth and equity, intersectoral growth (notably between agriculture and manufacturing) and short- and long-run efficiency maximization.

26. As with other institutions, the institutional capacity of the planning body to exercise its mandates and powers depends crucially on its human resources and its associated research bodies. Of course, the government vision of development also plays an important role; to an important extent, the prestige and powers of the planning body are shaped by that vision. For instance, owing to its specific style of development, the Economic Planning Board of the Republic of Korea, prior to its merger with the Ministry of Finance, had substantially more control over economic management than such ministries in other countries. It was extremely powerful, in terms of both authority and resources. The Thai National Economic and Social Development Board (NESDB) is also institutionally very capable. Its role in the budgetary process is, however, more limited and it is more focused on problems of efficiency, consistency and equity.

27. The planning bodies in the other sample countries have not been as fully developed. Many efforts towards institutional development have yet to be undertaken and what is particularly crucial in these cases, with perhaps the exception of Bangladesh, is the dearth of human resources, both in-house and in its associated think tanks, as well as a lack of adequate and timely information and data.

D. Coordination mechanisms

28. While the existence of coordination mechanisms is the rule rather than the exception in developing countries, including in the five countries studied, there are significant variations in format and institutionalization. Generally, there exists two types of coordination bodies: one deals with the formulation and execution of monetary policy, and the other with the fiscal policy process. The factors that contribute to the viability of a macroeconomic policy coordination mechanism include its mandate, powers, frequency of meetings and capability. Perhaps the best way to assess its capability is to look at the way it responds to a sudden economic crisis.

29. Various forms of a monetary board exist in all sample countries. In most countries, it consists of representative(s) from the ministry of finance, the central bank and the planning body with the minister of finance as chairman and the governor of the central bank as the vice-chairman. In the case of the Republic of Korea, representatives from the ministries of agriculture and trade and industry also sit on the board. This rather wide representation is exceptional and may have some positive effects on further ensuring consistency between the monetary and real sector policies.

30. The coordination body for fiscal policy typically involves a wider range of representatives, comprising almost all ministries and some agencies. Within the budgetary process, the planning body has more influence on capital expenditure, whereas the central bank tends to pay more attention to aggregate financial variables.

31. The credibility of any coordinating body depends partly on the strength of each participating ministry and agency. As expected, the coordination capacity in the Republic of Korea is better than in the other countries owing to the country's relatively long and successful history of institutional development as well as its strong government leadership style. This is not to say that there are no conflicting views or interests. Mounting and protracted problems of non-performing loans, for instance, have led the central bank, the Bank of Korea, to be more independent from government intervention.[2]

32. The intensity and quality of coordination also matter. The frequency of regular meetings, the quality of technical support papers, data availability and so on are all important factors contributing to the institutional credibility of the coordinating body. Little coordination appears to occur in Samoa where the Macroeconomic Coordinating Committee meets only three to four times per year, and even then, at the behest of the treasury department. In the absence of good technical policy papers, firm knowledge of short-term trends and the prospects of the macroeconomy is often lacking, so that policy coordination has to be attained through various and lengthy high-level meetings at which consensus is sought.

33. As governments generally have both macroeconomic and sectoral policies, the coordinating mechanisms between the financial and real sector agencies are important. These concern not only day-to-day economic management but also strategic issues such as the medium-term transformation of the economy and its policy regimes and the sequencing of liberalization.

III. MACROECONOMIC POLICY PROCESS

34. A few selected cases of the macroeconomic policy process are given below to provide some insights into institutional best practices and constraints in formulating and implementing policies.

A. Policy rules and guidelines

35. Discretionary fiscal and monetary policies are cast in economic textbooks as the privilege of governments, with little discussion on how this privilege is exercised. In practice, however, macroeconomic policies are seldom fully discretionary in nature; the practice of macroeconomic policies is usually constrained by a set of institutions which are anchored in the tradition of a country.

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[2] There were at least two attempts by the Bank of Korea, in 1989 and 1994, to be independent from government but in both cases the Bank was not fully successful.

In some countries explicit policy-governing rules exist which serve as built-in automatic stabilizers, such as rules or laws on balanced budgets, deficits or government foreign borrowing. In others, rules governing policy-making have long been rooted in history in an informal way. Both the Republic of Korea and Thailand appear to have succeeded in devising a conscious strategy of maintaining policy consistency and a disciplined approach to policy implementation. Fiscal prudence has long been characteristic of both countries and this has been attributed to various institutional constraints on financing fiscal deficits. The relatively larger fiscal deficits in other sample countries may have something to do with the absence of such institutionally binding constraints.[3]

36. In Thailand, there exist laws which control the magnitude of the budget deficits and government foreign borrowing. The 1959 budgetary law stipulated that the planned deficit, which is planned expenditure minus planned revenue, cannot exceed 20 per cent of planned expenditure. In 1973, the limit on spending was relaxed by an amendment to the effect that the deficit must not exceed 20 per cent plus 8 per cent of the repayments of principal of public debt. The budgetary law has been effective in restraining the growth of public expenditure; actual government spending has always been below the planned level. About the same time, a regulation on government foreign borrowing was issued which stipulated a 5 per cent ceiling on the ratio of public debt-servicing to exports and that foreign debt-servicing must be less than 13 per cent of planned revenue. The Foreign Debt Policy Commission was set up in 1960 to monitor and regulate foreign borrowing. The ceilings on the debt-service ratio and foreign debt service to planned revenue ratio were revised upward gradually in subsequent years to enable the financing of public investment by foreign borrowing. In 1977, the Foreign Debt Policy Commission was empowered to control the foreign borrowing of public enterprises. The maximum debt-servicing ratio was raised temporarily from 9 to 11 per cent for the period 1984-1987 to accommodate refinancing programmes. In 1986 the government imposed a ceiling of US$ 1 billion on foreign debt. This maximum amount has been adjusted upward regularly from year to year. The ceiling for the 1996 budget is US$ 3.7 billion, while the maximum public debt-servicing ratio remains at 9 per cent. The implementation of these fiscal rules have made the budget conservative and have served as a built-in stabilizer as the size of the budget is anti-cyclical. Moreover, the fact that this fiscal pattern has been ongoing for more than 30 years means that some strict rules have been institutionalized. The existence of these rules does not necessarily mean that political efforts to influence government expenditure have been absent; it merely emphasizes that such interference has been more difficult.

37. In the Republic of Korea, it is the overall economic plan that has provided fundamental policy guidelines for virtually all economic policies. For short-term policy purposes, notably the

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[3] Of course, this is not the whole story. In the Samoan case, the surge in government's fiscal deficits in the early 1990s was also caused by the need for urgent infrastructure rehabilitation following cyclone disasters.

implementation of monetary and fiscal policies, the basic strategic variables in the annual and semi-annual plan are derived consistently from the five-year plan. Within this framework the monetary target for the Bank of Korea is set and the government budget allocated. In the early 1980s oil price shocks and the consequent impact on the reduction in government revenue meant that not all projects in the plan could be financed. A new medium-term fiscal planning device was designed by creating a projection of resource mobilization and allocation on a rolling three-year basis, with the implication that all planned projects have to be supported within the required planned budget period. Now each planned project must have its own planned revenue prior to government's firm commitment to funding. This was to strengthen the notion of stability and predictability in government finance, which was critically needed during that crisis. As this mechanism continues, better resource allocation results in substantial efficiency increases and better public finance accountability.

38. The above cases refer to examples where some policy rules or guidelines have been firmly anchored, and thereupon prudent macroeconomic policy was formulated and implemented based on these anchors. A good track record in adhering to these rules helped to enhance institutional credibility over time, to create stable expectations and to discourage reckless government spending which often originates from short-term political goals. Another point that is worth mentioning concerns the flexibility in the implementation of these policy rules or guidelines such that in both cases they have been suitably tailored to respond to the economic challenges of the day.

B. Policy coordination and think tanks

39. In an institutional environment where there are imperfections, the policy coordination capacity becomes crucial. Indeed, policy coordination has been the hallmark of economic management in the Republic of Korea. This has been manifested in elaborate planning guidelines and solid mechanisms to ensure overall policy consistency. The exercise of the planning guidelines has been directed by the Economic Planning Board (which was later merged to create the Ministry of Finance and Economy) through a series of consultations with various ministries at various levels of the bureaucracy including its independent think tank, the prestigious Korea Development Institute. The policy constituency within the government is quite broad and virtually all economic ministries are represented. This sort of representation has been helpful in promoting cohesiveness in government economic policy implementation. To empower the coordination function, the minister of the Planning Board was appointed deputy prime minister. Policies were debated and revisions made under the coordination of the vice economic minister for planning. The outcome was then placed on the agenda of the economic ministers' meeting. This high-level meeting sets up the target range for annual money growth in conjunction with other targets of economic growth, inflation etc. The final authority for monetary policy was given to the Monetary Board, the supreme organ of the Bank of Korea which has nine members including the minister of finance as chairman of the Board, the governor of the

Bank as vice-chairman, and other members nominated by the ministers of finance, agriculture, and trade and industry. Although the target range of money growth was largely determined in the context of overall macroeconomic management, the Monetary Board must officially approve the suggested target range.

40. Similar coordinating features have been established in Thailand. The budgetary process involves scrutiny at various levels of the bureaucracy as well as coordination with various ministries and bodies. The Fiscal Policy Office is the economic think tank for the Ministry of Finance with the authority to formulate, recommend, and oversee the implementation of fiscal and financial policy for the government. Some recent policy initiatives include the introduction of the value added tax, foreign debt restructuring, and capital market measures to discourage insider trading in the stock market. In the annual budget preparations, the revenue, customs and excise departments of the Ministry participate, often assisted technically by the Thailand Development Research Institute, in suggesting the level of anticipated tax revenues for the next fiscal year. The Bank of Thailand, NESDB, the Fiscal Policy Office, the Comptroller-General's Department and the Bureau of Budget coordinate to determine the appropriate aggregate level of government spending. NESDB is involved in the budget preparation process to make sure that the proposed spending of each investment project contributes to high social rates of return. On the micro aspects of the budget, the Bureau of Budget is solely responsible for the allocation of the budgeted expenditure to different departments.

41. The elaborate mechanism of checks and balances, think tank support and multi-stage decision-making processes in the Republic of Korea and Thailand have helped enhance the commitment, understanding and participation of all relevant ministries at various layers of the administration. This in turn leads to more effective and efficient implementation. For the less endowed least developed countries, this elaborate policy process could be beyond their financial resources and so extreme care should be taken if such a process is to be emulated. Yet the principle of coordination which entails checks and balances and technical support needs to be established. Some economies of scale and scope in organization could be potentially achieved, for instance, by sharing scarce human capital, data and information, and technical support.

C. Capital inflows and coercive sterilization

42. Extreme volatility in macroeconomic variables has been a daily menu for policy makers over the last decade. Yet, the fact that the effectiveness of some policy instruments is constrained by various imperfections in the domestic money market has added to complications in policy implementation. At some critical moment, the policy maker's correct judgement of the situation, coupled with a strong determination to use coercive measures if and when necessary, is the way to survive in the imperfect policy environment. The case of sudden increases in capital inflows in the Republic of Korea and Thailand is instructive.

43. In the wake of an unprecedented surge in capital inflows in the late 1980s, which was generated by a huge current account surplus, the Bank of Korea undertook prompt coercive measures to sterilize the excess money supply by forcing financial institutions to buy monetary stabilization bonds at a rate of interest lower than that prevailing in the market. This emergency action was necessitated by the impending threats of domestic inflation and the erosion of export competitiveness. Such coercive measures were undertaken because the domestic money market was thin and relatively underdeveloped.

44. To some important extent, inflationary pressures in Thailand in the early 1990s stemmed from the effects of financial liberalization. With the domestic monetary condition relatively tight, the gap between the domestic and international interest rates widened, thus giving rise to surges in capital inflows. As the inflows were monetized, the domestic money supply increased, thereby exerting pressures for inflation and for the currency to appreciate. Owing to the magnitude of the inflow Thailand's fiscal surplus was not able to offset these increases in the domestic money supply. As exchange rate stability remained the priority of the government and Thailand's banking credit rating dropped,[4] the Bank of Thailand took direct measures to control the capital inflows. In 1995, the Bank of Thailand imposed capital restrictions to curb short-term capital inflows, including (a) imposing a reserve requirement for the out-in business of Bangkok International Banking Facilities, (b) raising the minimum amount of loans made through this facility from 500,000 baht to 2 million baht, and subsequently to 5 million baht, (c) raising cash reserve requirements for non-resident baht accounts from 2 to 7 per cent, and (d) imposing a 7 per cent reserve requirement for the foreign borrowing of financial institutions. In the short run at least, these measures seemed effective in dampening the excess supply of money and reducing foreign borrowing through the facility.

45. The above cases illustrate that the determination of the government to maintain macroeconomic stability is crucial and that there are ways to cope with the problems even when the policy environment is imperfect. Of course, it is critical to judge correctly whether the existing disequilibrium is temporary or permanent. This is why it is important to monitor and analyse the situation continuously. It also explains why think tanks play an important role as independent watchers.

D. Large foreign aid inflows

46. Capital inflows from foreign aid may generate problems in economic management. The lengthy and unstandardized procedures, which are usually different from one donor to another, can create unpredictability in capital inflows.

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[4] In August 1996, Moody Credit Rating Agency downgraded some Thai commercial banks from prime 1 to prime 2 owing to excessive foreign short-term debt exposure.

47. In Bangladesh, foreign reserves accumulated rapidly during 1995 as there were increases in foreign transfers (for example, workers remittances) following exchange rate liberalization as well as a build-up in the aid pipeline to about $6 billion at the end of 1994. As import demand remained sluggish, the increase in domestic money supply was partly spent on non-tradables, creating a sort of Dutch disease phenomenon and threatening export competitiveness. The capacity of the central bank to respond immediately to the critical economic situation was limited, yet it is precisely this sort of capability which is crucial for managing short-run stability. In the longer run, however, there is an urgent need to streamline the foreign aid disbursement process by developing a better coordination framework and some standardization of the system and procedures.

48. The Laotian case was somewhat a mixed blessing. Late disbursements of foreign aid exposed the country's vulnerability in maintaining a fixed exchange rate system. From the third quarter 1994 through the first half of 1995, the central bank was running short of foreign exchange owing to the delays in many programme loans from international organizations. The demand of the main importers for foreign exchange was not met by the banks, so they had to resort to the parallel market. By mid-May 1995, the combination of high liquidity in the market, rising inflation and speculation led to a devaluation of the new kip in the parallel market by some 15 per cent over the previous month. In just two months, during May and June 1995, the government had to devalue the official exchange rate three times. At the same time, it introduced administrative controls, including the withdrawal of the licenses of exchange bureaux that did not comply with the central bank's regulations, price surveillance over a number of commodities, and foreign exchange restrictions. But these measures failed to stabilize the foreign exchange market, and the exchange rate in the parallel market continued to depreciate. The government decided to go for a floating exchange rate regime in two steps. In the first step, beginning in August 1995, the central bank issued a notification to allow the leading commercial bank, which happened to be State-owned, to set the rate which it considered competitive with the parallel market rate. Other banks and licensed exchange bureaux had to follow that rate while the official rate was unchanged. When the commercial bank rates and parallel rates seemed to have stabilized, the authorities moved to the second step of abandoning the official rate, lifting all outstanding exchange restrictions and announcing a freely floating exchange rate system. The government managed to keep the economic situation under control towards the last quarter of 1995 because of the reconciliations made between the major economic ministries, namely the Committee for Planning and Cooperation, the Ministry of Finance, the Bank of the Lao People's Democratic Republic and the Ministry of Trade. Low priority public investment projects were scrapped or delayed and current government expenditure was strictly contained (by the Ministry of Finance), while there was close surveillance of prices in the markets, particularly the prices of daily consumption goods (by the Ministry of Trade). The central bank did its part by issuing new kip 15 billion of Central Bank

securities to the public in addition to a regular bi-weekly auction of T-bills supported by credit ceilings imposed on commercial banks. From the macroeconomic policy coordinating side, the crisis seems to have enhanced interactions among various ministries and government agencies, whose successful experience will be beneficial for future policy coordination.

E. Financial sector development and liberalization

49. The aim of various deregulation and liberalization measures in the financial market is to enhance those competitive mechanisms that would eventually make the economy more efficient and the domestic macroeconomic conditions more consistent with the country's competitive position in the global economy. However, results in developing countries have so far been less than encouraging. Many argue that the major problem does not necessarily lie with financial liberalization policy per se but with the structure of the financial sector and its supervision.[5] Perhaps owing to a relatively less strict supervisory framework for non-bank institutions, the disintermediation process of the banking system has been going on very rapidly resulting in sizeable and growing portion of the deposits and loans which are now provided by non-bank institutions. Stricter and wider coverage of prudential rules as well as their harmonization among institutions is one requirement. Another urgent institutional development concerns the introduction of more competition in the financial sector. These challenge the institutional capacity of a central bank and/or ministry of finance to supervise and develop the financial sector.

50. Financial opening in Thailand, for instance, induced a rapid disintermediation process of the banking system as the stock and bond markets developed. The share of saving mobilized by banks declined from 79 per cent in 1991 to 45 per cent in 1994. The structure of credit also changed significantly; the proportion of commercial bank credit in total incremental credit declined from 75 per cent in 1991 to 40 per cent in 1994. With a greater degree of credit substitution, the oligopolistic power of the commercial bank was being reduced, as was the power of the central bank to influence the money supply. While there was increased competition in the financial sector, this has put increased domestic inflationary pressures.

51. In Samoa, non-bank financial institutions, whose numbers have increased rapidly, remain beyond the scope of the central bank's supervision. Particularly because the pace of transition has been remarkably fast, some serious concerns about the destabilizing effects of the loans provided by

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[5] See, for instance, Carlos Diaz-Alejandro, "Good-bye financial repression, hello financial crash", *Journal of Development Economics*, vol. 19, No. 1 (1985); Delano Vilanueva and Abbas Mirakhov, "Strategies for financial reform", *IMF Staff Papers*, vol. 37, No. 3 (September 1990); Jose de Gregorio and Pablo E. Guidotti, "Financial development and economic growth", *World Development*, vol. 23, No. 3 (March 1995); as well as John Willamson, "A cost and benefit analysis of capital account liberalization"; Helmut Reisen, "Macroeconomic policies towards capital account convertability"; Bernhard Fischer, "Impediments on the domestic banking sector to financial opening" in Helmut Reisen and Bernhard Fischer, eds., *Financial opening: policy issues and experiences in developing countries* (Paris, OECD Development Centre, 1992).

the non-bank financial institutions have been raised. Although the new legislation being drafted to subject the non-bank financial institutions to central bank supervision is necessary, this will not be sufficient unless adequate provision for further development of the central bank's own institutional capacity is carried out so that it can exercise its prudential regulations effectively.

52. In Malaysia, following a series of economic and financial crises in the mid-1980s, the government took prompt measures to tighten supervision of the financial sector. Under the Banking and Financial Institutions Act enacted in 1989, comprehensive powers have been granted to the central bank to supervise a broad group of financial institutions, including commercial banks, merchant banks, financial companies, credit and charge card companies, building societies, factoring and leasing companies, development finance institutions and insurance companies.[6]

53. In countries with a relatively low degree of monetization and a neighbouring large and strong economy, financial opening could easily induce the erosion of the domestic currency base and, at the same time, give rise to a dual or multiple currency system in the economy. This complicates monetary policy as the monetary authority loses its control over the domestic money supply. The Lao People's Democratic Republic is a case in point. Foreign currency bank accounts have been increasing rapidly and, by the end of 1995, about one half of bank savings were in foreign currency. In addition, a growing proportion of daily trading activities, especially in the border areas, has been conducted in foreign currencies, particularly in baht or dollars. In this regard, exchange rate coordination or cooperation with either the other small neighbouring countries or the big neighbouring country or both is worth exploring.

F. Efforts to build institutional capacity

54. It is obvious that to develop a sound institutional capacity a conscious strategy is needed. In both the Republic of Korea and Thailand, there have been various schemes to develop human resources. Generous fellowships and research grants have been offered to the most talented people to pursue postgraduate studies overseas. Often this has been coupled with sponsoring secondment arrangements in overseas institutions, including universities, research centres and international organizations. In addition, at the initial stage of their development, attractive remuneration packages were offered to professionals working overseas to encourage them to return home to staff the central bank, the ministry of finance and the planning body. In some instances, especially in the case of the Republic of Korea, a competitive remuneration scheme was also offered to expatriates in order to attract world class talent.

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[6] See Lin See Yan, "The institutional perspective of financial market reform: the Malaysian experience" in Shakil Faruqi, ed., *Financial Sector Reform in Asian and Latin American Countries* (Washington, DC: The World Bank, EDI Seminar Series, 1993).

55. Close coordination among the macroeconomic institutions has been promoted through schemes of secondment between themselves. In both countries, the think tanks have also been involved in the secondment schemes and in providing technical assistance and training to government officers and politicians. In short, a market-based strategy to promote human resources development has been employed consistently in order to attract the intellectual elite to the bureaucracy.

56. There is growing cooperation between the developing countries with respect to institutional development. For example, the Korean Development Institute has recently been active in providing technical assistance to develop the Viet Nam Development Institute. This assistance involves exchange of officers, research grants and the development of data and information systems. More efforts in this direction are urgently needed to assist the least developed countries.

IV. CONCLUSIONS AND RECOMMENDATIONS

57. The following recommendations are submitted for consideration by the Special Body:

(1) The credibility of macroeconomic institutions and policies as perceived by various economic agents needs to be established through a clear and conscious strategy. These institutions should be granted well-defined mandates and powers to accomplish their task. Formal macroeconomic coordinating committees or mechanisms which meet regularly and frequently need to be given prominence within the decision-making process in order to ensure overall policy consistency. The triumvirate institutions - the finance ministry, the central bank and the planning body - should be standing members of the coordinating committees; other ministries need to be involved, especially when the impacts of policy changes are likely to have sectoral effects.

(2) To further ensure policy consistency over a period of years, a long-term planning vision should be formed, subject to flexible revisions of the intermediate macroeconomic targets through the coordinating committees. Establishing formal fiscal balance rules may assist in maintaining financial and economic stability. Other guidelines, such as limits of foreign borrowing, foreign debt-service ratios, and limits of government borrowing from the central bank should be adopted only through discussion in the committees.

(3) The existence of autonomous macroeconomic think tanks staffed by technocrats from the government, the private sector and academia is necessary to provide credible policy advice. Human resources development schemes should promote education and training to attract and keep competent individuals at all levels of various ministries and agencies. The macroeconomic think tanks can also be used to provide training for government officials and elected representatives.

(4) Since policy objectives need to be understood by all participants, public debates are necessary. Consultations with the private sector may also be beneficial in generating support for policies and soliciting inputs to policy changes.

(5) Data systems for macroeconomic variables need to be kept up to date, and they should be rapidly available, consistent and reliable; while data can be collected by the different relevant agencies, there should be some coordination without forcing uniformity.

(6) There is a need for the central bank to be credible, and for it to be viewed as having a high degree of authority and prestige within a country. Thus it should have a fair degree of independence; for example, it could be a statutory corporation or a public entity, with the board of governors fairly widely representative of the economy and composed of well respected individuals. The notion of institutional independence is, however, not absolute. Some independence should be granted to the technocrats so that they can provide professional expert advice to policy makers.

(7) Since payment of tax obligations is not well accepted or understood as a civic responsibility, public education campaigns are necessary. A simple, transparent and fair system of raising revenue is required, using instruments that are easy to understand and administer. In addition, more efforts to develop the capabilities of the tax administration are needed.

(8) Experience suggests that financial development should first focus on the banking system before the capital markets. Expanding entry (and exit) of financial institutions and the range of financial products should take into account the supervisory capability of the central bank. Owing to the variety of financial institutions, the standardization of prudential rules and the consolidation of supervision of the entire financial sector may be necessary.

(9) To manage inflows of overseas development assistance, an institution in the ministry of finance or the planning body should handle and coordinate aid inflows among various ministries and donors. Owing to heterogeneity in donor interests and procedures, the institution also needs to be able to promote coordination with the private sector and non-governmental organizations.

(10) Since institutions evolve over time in response to the economic and political environment, they cannot simply be copied from one country to another. However technical and economic cooperation among developing countries should be fostered to provide support for institution-building in least developed countries for policy formulation, technical implementation and human resources development.